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HEADLINE: After IPO, Can Ads Keep Fueling Google?

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BODY:

GOOGLE INC.'S success is founded on the sweat and dreams of a corps of brainy engineers and a search site that consumers prefer to rivals. But its fate as a public company will rest on something historically fickle: Internet advertising.

The Mountain View, Calif., company is expected to announce plans for an initial public offering in coming days, according to people familiar with the matter. Google's filing with the Securities and Exchange Commission will shed light on previously secret details about its business, including how much money the company makes.

Even before any disclosure is filed, however, one stark fact is clear: Google's future profitability will hinge primarily on its ability to sell more online ads. The company and many analysts are confident it has the right recipe. But the brutal falloff in Internet ad spending after 2000, which ravaged a previous generation of highfliers, offers a cautionary tale. A Google spokeswoman decined to comment.

Google collected roughly $1 billion in revenue last year, according to people familiar with the matter. But only a small share of that money came directly from its search technology. Google offers its search engine to Internet users free of charge. It also licenses the technology to organizations such as Procter & Gamble Co. and the U.S. Army for their internal use and to Web sites such as Time Warner Inc.'s America Online unit to power consumer searches.

Most of Google's revenue comes from small text ads that Google sells on its own site, as well as the Web pages of other companies. Advertisers bid for the right to have ads appear each time a user searches for certain keywords or those words appear on the Web site of a Google partner. Across the search industry, advertisers agree to pay an average of roughly 40 cents each time a user clicks on an ad. Rates for some much sought-after terms can go much higher: Google caps them at $50. It says it has more than 150,000 advertisers to such services, ranging from Ford Motor Co. to online retailer drugstore.com Inc.

The advertising is lucrative. Google began selling the ads in 2000, adapting a practice commercialized by Overture Services Inc., now part of Yahoo Inc. Google quickly grabbed a commanding position in search ad sales because of the popularity of its search engine. As a result, the company has been profitable since 2001, company executives say.

Advertisers spent $2.5 billion on ads targeting key search words in 2003, nearly triple the $927 million of ads sold the year before, estimates eMarketer Inc., a New York research firm. Analysts and Web moguls are optimistic about the future of these online ads, because they're focused on users interested in a subject, and so are considered much more effective than banner ads, which are strips of ads appearing alongside the content of Web pages not tied to a specific search.

But many of these same analysts have been wrong before. In the late 1990s, they predicted exponential growth in online advertising, centered on those very banner ads. Instead, amid a broad downturn in ad spending, advertisers turned against banners because of declining consumer response. Online advertising plunged to $6 billion in 2002, from $8.2 billion in 2000, according to eMarketer.

As search-related ads have surged, online advertising rebounded strongly last year, to $7.3 billion. Still, that remains below the 2000 peak.

As a public company, one of Google's biggest challenges will be simply to manage expectations about its growth. Some analysts say Google's revenue-growth rate is bound to slow, if only because each percentage increase gets harder as the numbers get bigger.

"I'm quite bullish on the Internet search advertising market," says Charlene Li, a principal analyst with Forrester Research Inc. in San Francisco. "But is it going to continue to grow at 200%? No."

To boost growth, Google hopes to expand where and how often consumers see its advertisers' pitches. For example, the Gmail e-mail service it began testing this month matches ads to the content of users' incoming e-mails.

Google also is reaching out to large advertisers by making it easier for them to create and manage massive numbers of keyword search ads. For roughly the past two months, Google has been offering to analyze companies' Web sites and suggest keywords for ads based on the sites' product information. For a lawn-mower maker, for example, Google might suggest ads linked to such terms as "riding mower," "push mower" and "gas-powered mower," and create Web links to appropriate products.

The company also is pushing to sell ads based on a user's location, which Google can estimate in some cases through a computer's IP address. Google also started selling ads based on a place that is the subject of a search. That would let Google tap a large market of local advertisers who typically use the Yellow Pages and other regional advertising outlets. "In the middle of winter, you can target snow shovel ads to places where it's cold," said Tim Armstrong, Google's vice president for advertising.

But reaching beyond its own search pages doesn't always pack the same marketing punch. Google has acknowledged that ads it places on other Web sites don't deliver users as effectively as the ads on its own site.

"One of the questions still out there is whether the brand extension will be successful," says David Hallerman, a senior analyst at eMarketer.

In addition, Google's success is breeding increased competition. Once an ally, rival Yahoo now offers similar capabilities in both search and contextual ads. And Microsoft Corp., which has a history of entering markets late but then dominating them, is planning its own attack with a search engine expected later this year.

Google handled an estimated 35% of all U.S. online searches in February, says research firm comScore Networks Inc. That narrowly tops Yahoo, which handled about 30% of searches. And Google's lead is shrinking: Yahoo gained roughly two percentage points in the six months leading up to February, helped by its Overture acquisition. If rivals steal away searchers, they're likely to capture more ad revenue as well -- at Google's expense.

A shift in advertiser sentiment away from the small text ad format also could threaten Google's revenue stream. Some analysts expect corporate-branding campaigns to drive a new wave of Internet advertising. Google wouldn't be in a good position to capitalize on that shift, these analysts say, because its existing ad format is better-suited for companies trying to sell something immediately.

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